[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 5076

RELATING TO

STATE TAXATION OF FOREIGN SOURCE CORPORATE INCOME

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON MARCH 31, 1980

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

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INTRODUCTION

This pamphlet provides a description of a legislative proposal (H.R. 5076) relating to limitations on State taxation of foreign source corporate income, which is scheduled for a public hearing on March 31, 1980, by the Committee on Ways and Means.

The first part of the pamphlet is a summary. Part II is an explanation of present law regarding State and Federal taxation of multinational corporations. Part III provides discussion of Federal limitations on State taxation of foreign source income. Part IV sets forth the principal issues involved, and Part V is a description of the provisions of H.R. 5076.

I. SUMMARY

State taxation of corporations

At present, States generally tax the income of corporations doing business within and outside the State by apportioning the income pursuant to a formula—this is commonly referred to as the unitary method. The States have adopted several different approaches to apply the unitary method to apportion the income of affiliated groups of corporations. Some States take into account the operations of foreign affiliates of the corporation doing business in the State to the extent that the foreign affiliates and the U.S. corporation are engaged in phases of a single "unitary" business. The practices of States in taxing dividend income from affiliated corporations also varies, depending in part on whether the income from which the dividend was paid was already subject to tax pursuant to apportionment. These State rules for determining the amount of income subject to tax differ in a number of respects from the methods employed by the Federal government to determine the tax liability of multinational corporations.

Federal limitations on State taxation of corporations

Although the Constitution imposes some limitations on State apportionment methods, generally the States have considerable flexibility in determining their rules. The Congress in 1959 enacted limited legislation dealing with State jurisdiction to tax, but has not prescribed any additional rules.

Legislative proposal: H.R. 5076

H.R. 5076, introduced by Messrs. Conable and Jones, would limit the manner in which States could tax income of foreign affiliates. Under the bill, States and localities would generally be prohibited, in applying their income tax to a corporation, from taking into account the income of any related foreign corporation. The provisions of the bill would apply regardless of whether the parent corporation of the group is foreign or domestic. In addition, the bill would limit the ability of States and localities to apply an income tax to dividends received by a corporation from foreign corporations. Generally, some or all of the dividends would be exempted from State taxation in order to take into account foreign taxes paid on that income. A separate exemption is provided in the case of dividends from U.S. corporations substantially all of whose income is from foreign sources.

II. PRESENT LAW

A. Unitary Method of Apportionment for State Taxation of Corporate Income

The question of State taxation of foreign source income is one aspect of the larger question of State taxation of businesses operating in more than one State. This larger question involves the problem of determining a State's jurisdiction for taxing a corporation's income and rules for apportioning and allocating that income among the States in which a corporation does business. Of the 45 States which impose a corporate income tax, all use some kind of formula to apportion business income between the various States in which a corporation operates. However, the specific formula used varies substantially from State to State.

In 1969, a group of States reacted to the possibility of Federal legislation (which would have required greater uniformity in apportionment) by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards and tax forms for member States. The Commission also established uniform rules regarding the allocation and apportionment of State corporate income. Presently, 19 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if it chooses. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary among States which are members of the compact. (The authority of the Multistate Tax Commission to operate as agent of the States in enforcing their corporate income tax laws was upheld by the U.S. Supreme Court in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978).)

Unitary method

The unitary method requires two steps for the apportionment of income to a particular State. First, the total amount of income subject to apportionment is determined. Second, the apportionable income is multiplied by a formula intended to reflect the portion of that income earned within the State. The resulting product is subject to the State's taxation.

Formula.—In determining income earned within a State, most States use some variation of a basic three-factor apportionment formula. Under this formula, the income of a business is apportioned to each State according to the average ratio of three factors: the sales, payroll, and tangible property values of the business in the State to the total sales, payroll, and tangible property values of the business. For example, a corporation which has one-half of the value of its tangible

property, three-fourths of its payroll, and one-fourth of its sales in a particular State would take the average of these three fractions (or one-half) to determine the amount of income subject to tax in that State.[1]

Apportionable income.—A State's apportionment formula is applied only to that income of a corporation which is from a unitary business. In general, a corporation has a unitary business when the business activity from within the State is dependent upon, or contributes to, business activities of the same corporation outside of the State. Where the business activity in the State is unrelated to other businesses of the corporation outside of the State, so that there is no unitary business which is conducted in part within and in part without the State, all of the income from that business within that State is allocated to, and thus is taxed by, that State and the income from the other businesses conducted outside the State is not allocated to, or taxed by, the State.

Virtually all States include the income and tangible property payroll, and sales of foreign branches of domestic corporations in the income which is subject to their apportionment formula. For example, if a corporation had two-thirds of its sales abroad, but had the other one-third of its sales, one-half of its property, and two-thirds of its payroll in one State, the corporation would be taxed on one-half of its income by that State.

In general, a unitary business is considered to exist where, for example, a product is manufactured in one State and sold in another State or where a product is partially manufactured in one State and then shipped to another State where the manufacturing is completed. The requirement to apportion income derives from the difficulty in determining how much of the total net income is attributable to the manufacturing operation and how much to the sales activity, in the first situation, and to the two manufacturing operations in the second situation. However, such direct integration of business operations is not the sole criterion that has been used by the States to establish the existence of a unitary business. In some cases, the touchstone for establishment of a unitary business has been centralized management or centralized purchasing. A unitary business has also been held to exist where the home office used the assets of an otherwise unrelated business operations as collateral for a loan and, with respect to investment securitis, where the securities were purchased from operating income.

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in some States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (generally the State of the "principal business location") of the corporation and is thus excluded from the income subject to the apportionment formula.

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[1] Those States which do not follow this three-factor formula use other apportionment formulas, some based on sales only and others based on a combination of sales and property or sales and payroll or property and payroll. Even among those States which do use the basic three-factor formula, the manner of measuring the three items in the formula may differ. For example, in some States a sale is taken into account by the State where the sale originated (generally, the location of the seller) while in other States the sale is allocated to the State of destination (generally where the buyer is located).

Combined reporting

The States have adopted several different approaches to apply the unitary method to apportion income of affiliated groups of corporations (parent, subsidiary, and brother-sister corporations). Some States apportion on a corporation by corporation basis, and the income and business operations of affiliated corporations are not taken into account even where those operations are directly related to the business operations of the affiliates operating within and taxed by the State. However, most States in at least some circumstances combine (either mandatorily or at the taxpayer's election) the income and related business operations of some or all affiliated corporations which operate a unitary business and the combined income is apportioned within and without the State in accordance with the combined property, payroll, and sales factors for the unitary business of the group within and without the State. Application of the unitary method in this manner is referred to as "combined reporting" and is analogous to the filing of a consolidated return for Federal tax purposes.

Worldwide combination.—Most States which use the combined reporting approach of applying the unitary method in the case of affiliated groups typically limit the affiliated corporations included in the combined report to the U.S. corporations within the group and, as in the case of the Federal consolidated return provisions, the operations of foreign corporations are not taken into account. However, several States (most notably California and certain other members of the multistate compact) include the operations of foreign affiliates in the combined report where those operations are dependent upon or contribute to the activities of the U.S. affiliates within the taxing State. This is generally referred to as the application of the unitary method on a "worldwide combination" basis. Some of these States (e.g., California) require the inclusion of foreign affiliates involved in the unitary business as a matter of course; others include foreign affiliates only on occasion. In applying the unitary method on a worldwide combination basis, the income of foreign affiliates is treated in much the same manner as most States treat income of foreign branches of U.S. corporations.

Considerable controversy has surrounded the requirement by these States that the operations and income of foreign affiliates be included in the combined report. The proposed legislation which is the subject of the current Ways and Means Committee hearings (see Part V.A. of this pamphlet) is directed at this application by States of the unitary method on a worldwide combination basis.

California legislative proposals.—The California Legislature currently has a bill before it that would, in certain circumstances, restrict the State's ability to take into account (under its worldwide combination system) the operations of foreign affiliates of corporations subject to California taxation. The bill, A.B. 525 (the Hughes-Mori bill), provides that corporations subject to tax in California, if they are more that 50-percent foreign owned, will not be required to include in their California combined tax return the operations of foreign affiliates. This exclusion from combined reporting is not available, however, in the case of corporations having operations in the areas of agricultural land, energy, and steel.

A.B. 525 was passed by the California State Assembly on January 30, 1980. Hearings before the Senate Committee on Revenue and Taxation were held on March 26, 1980. Additional hearings are scheduled before that committee in April 1980.

The bill contains a provision that would automatically terminate the bill if Proposition 9 (sometimes referred to as "Jarvis II") is passed by the voters of California. Proposition 9 would substantially reduce California individual income tax rates.

B. State Taxation of Dividends from Foreign Corporations

Almost all States imposing a corporate income tax, tax corporations on foreign source dividends in at least some situations. A few States completely exempt dividends or at least all dividends received from foreign corporations (including deemed dividends of tax haven income taxable for Federal income tax purposes under subpart F of the Code). Some of the States which do tax dividends do not include the dividends in the income to be apportioned by the unitary method among the States. (This is particularly the case where the dividends are not received from a subsidiary out of earnings from business operations of the subsidiary which are related to those carried on in the State by the U.S. corporation.) These States generally allocate the dividends, and thus jurisdiction to tax, entirely to the U.S. corporation's State of commercial domicile.

The majority of States in at least some cases include dividends in the income to be apportioned among, and taxed by, the various States pursuant to the unitary method. In those States where the income and payroll, sales, and property factors of the foreign subsidiary are taken into account through worldwide combination in determining the income of the U.S. parent to be apportioned to the taxing State (e.g. the California system), dividends distributed by the foreign corporation out of the unitary business are not included in the income to be allocated or apportioned and are exempt from tax. However, dividends which are not out of the unitary business income which has been taken into account in computing the U.S. corporation's apportionment formula are included in income and are taxed when distributed. In other States which tax dividends from a foreign subsidiary carrying on a unitary business with the U.S. parent, but which do not tax the foreign subsidiary's income as it is earned pursuant to a combined reporting method (e.g., the Vermont system considered in the *Mobil* case), the entire dividend may be included in income and apportioned in accordance with the payroll sales, and property factors of the U.S. corporation (which would allocate to the State a higher portion of the income being apportioned since the foreign factors are not taken into account). This is because the income from which the dividend is paid was not previously subject to tax.

C. Comparison With Federal Taxation of Multinational Corporations

In general

For Federal income tax purposes, U.S. corporations (those incorporated in the United States) are taxable on their worldwide income—both from sources within and without the United States. The United States does, however, unilaterally cede primary jurisdiction to tax foreign source income to foreign governments by the allowance of a credit for the foreign income taxes paid on foreign source income. (The foreign tax credit is limited to the precredit U.S. tax attributable to foreign source income.) The foreign tax credit is allowed for foreign income taxes imposed by provinces, cities, and other political subdivisions as well as those imposed by national governments.

The Federal rules applicable to foreign corporations (those incorporated outside the United States) are more directly analogous to the State rules previously discussed—foreign corporations are generally subject to Federal income tax only on their U.S. source income. This is true even in the case of foreign subsidiaries of a U.S. corporation—their foreign income is not taxable by the United States directly. However, if and when the income earned by a foreign subsidiary is distributed (or deemed distributed) as a dividend, the dividend is taxable to its U.S. shareholders. U.S. corporate shareholders with at least a 10-percent ownership interest in the foreign corporation are allowed a deemed paid foreign tax credit for their portion of the foreign taxes paid by the subsidiary which are attributable to the dividend.

The Federal rules do not follow the approach generally used by the States of aggregating all the income of the business and then apportioning it in accordance with a single formula to determine the taxable income from sources within the State. Instead, as outlined below, the Federal system attempts to determine the taxable income on an item by item basis.

Section 482

Because U.S. corporations are fully taxable by the United States on their worldwide income while their foreign affiliates (either foreign subsidiaries in the case of a U.S. multinational or foreign parent and affiliates in the case of foreign multinationals) are generally taxable only on their U.S. source income, there is an incentive for U.S. corporations to divert income to their foreign affiliates by distorting their intercompany transfer pricing. Because of this potential, code section 482 authorizes the Internal Revenue Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities if it determines that it is necessary in order to prevent evasion of taxes or clearly to reflect income.

In 1966, regulations were issued interpreting section 482 which generally provide that in any transaction among members of a controlled group of corporations, the affiliate receiving a benefit from a related

corporation must make adequate reimbursement for the benefit. The regulations provide detailed standards for determining whether the intercompany pricing arrangements were adequate—the rules cover the pricing of sales of tangible property by one member of a controlled group to another, the use by one affiliate of the intangible property (patents, copyrights, trademarks, know-how, etc.) owned by another, intercompany loans, services provided by one affiliate to another, and other intercompany transactions. The rules generally apply an arm's-length standard—that is, they generally require that the intercompany pricing be the same as the prices which would be charged between two unrelated companies.[2]

This arm's-length standard is essentially the same standard used by other countries to govern the intercompany pricing arrangements of multinational corporate groups operating within their jurisdiction. This method is also used by those States which do not include foreign affiliates in the combined report. Since these States generally only apportion (and thus tax) only the income of the U.S. members of the group, it is important that the income of the U.S. affiliates is not artificially diverted to the non-taxed foreign affiliates. As a practical matter, these States rely on the Internal Revenue Service to police the intercompany pricing of multinationals. This method contrasts with the combined reporting methods used by many States, under which intercompany pricing is not relevant because the income and deductions of the affiliated companies are combined and apportioned pursuant to a formula. In much the same way, intercompany pricing is generally not important for federal tax purposes in the case of transactions between related U.S. corporations included in a consolidated return.

Allocation and apportionment of income and deductions

The rules for determining whether the income of a taxpayer is from sources within or without the United States are set forth in Code sections 861 through 864. As indicated above, the source of taxable income is important in the case of a U.S. corporation because its foreign tax credit is limited to its pre-credit U.S. tax allocable to its foreign source income, and it is important in the case of a foreign corporation because its U.S. tax is based on its income from U.S. sources.

These rules operate by first specifying a particular source for the various items of gross income earned by the taxpayer (interest and dividends received from U.S. corporations are generally treated as U.S.

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[2] The House-passed version of the Revenue Act of 1962 contained an amendment to section 482 which provided special rules for allocating taxable income arising from sales of tangible property within a related group which includes foreign corporations. The allocation was to be made by taking into consideration that portion of the payroll, property, expenses, and other factors of the group attributable to the United States and that portion which is not. Although this method is somewhat analogous to the application of the unitary method on a combined reporting basis, it was to be applied only with respect to income from intercompany sales rather than with respect to the entire operations of the group. The provision was deleted from the bill as finally enacted because the Conferees agreed that Treasury had the authority to prescribe under section 482 rules which would accomplish that objective and Treasury was directed to explore the possibility of promulgating regulations which would do so. As noted above, the regulations promulgated in response to this direction generally adopted a different approach.

source income; income from the performance of services are generally sourced where the services are performed, etc.). After the source of the various items of gross income has been determined, taxable income from sources within and without the United States is determined by deducting from each the expenses, losses, and other deductions properly apportioned or allocated to each, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (Code secs. 861(b) and 862(b)).

The regulations (Treas. Reg. § 1.861–8) set forth detailed rules for the allocation and apportionment of deductions to U.S. and foreign source gross income. These rules provide in certain circumstances for the apportionment of deductions of a U.S. corporation on the basis of assets or sales of all corporations within the controlled group, including the foreign subsidiaries.

III. FEDERAL LIMITATIONS ON STATE TAXATION OF FOREIGN SOURCE INCOME

A. Constitutional Limitations

A number of recent Supreme Court cases are particularly relevant to constitutional limitations on State income taxation.

***Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978)**

Moorman dealt with the application of the unitary method in connection with interstate, rather than foreign, commerce, but it would appear to be of general application. The case sustained Iowa's single-factor sales formula for apportioning income against a constitutional challenge. The Court first held that there had been no violation of the Due Process clause. The Court rejected Moorman's argument that it was unconstitutionally taxed on the same income by both Iowa and Illinois because Moorman could not prove, under a separate accounting analysis, that Iowa taxed its out-of-State income. The Court held that it was not necessary for a State's apportionment formula to result in tax on no more than the exact amount of income earned in the State. Generally, a State tax would be upheld so long as there was at least a minimal connection between the activities being taxed and the State, and the income attributed to the State was rationally related to the values of the enterprise there. A single-fatcor formula would presumptively meet the second test, unless there was clear evidence in a particular case that the results were grossly distorted. The Court ruled that Moorman had made no such factual showing.

The Court also held that, in the absence of an actual showing of double taxation, it would not find that Iowa's formula violated the Commerce Clause. The Court declined to hold that the formula must be invalidated if there were a mere possibility of double taxation, pointing out that this would require the Court to prescribe in detail a single uniform allocation formula by which all the States would be bound. The Court did point out, however, that the legislative power granted to the Congress under the Commerce Clause would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.

***Japan Lines, Ltd.* v. *County of Los Angeles*, 441, U.S. 434 (1979)**

In this case, the Court considered whether or not a California property tax imposed an unconstitutional burden in cases where the tax was imposed on ships' cargo containers which were utilized exclusively in foreign commerce. The containers were owned, based and registered abroad. In finding that the tax was unconstitutional, the Court held that it was not enough that the tax meet the requirements applicable to State taxation of instrumentalities of interstate commerce: that the tax be on an activity with a substantial nexus to the taxing State, be

fairly apportioned, be nondiscriminatory, and be fairly related to services provided by the State. Rather, the Court observed that there were two additional considerations where instrumentalities of *foreign* commerce were involved. First, multiple taxation was a greater possibility because no one tribunal was available to reconcile the claims of the competing taxing jurisdictions. Second, the State tax might prevent the United States from speaking with one voice when regulating commercial relations with foreign governments. The Court held that California tax failed both of these tests.

***Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. —— (1980)**

Under the Vermont tax system, foreign source dividends received by a U.S. corporation doing business in Vermont are included in the income subject to apportionment pursuant to Vermont's three-factor formula and the amount apportioned to Vermont is subject to its corporate income tax. Mobil challenged taxation by Vermont of the foreign source dividend income received by Mobil from its affiliates. (These were generally foreign corporations, although dividends from ARAMCO, a U.S. corporation operating in Saudi Arabia, were also involved.) Mobil argued that the dividend income should instead be allocated in its entirety to New York, the State of its corporate domicile. (Under New York law, however, the foreign dividend income would be exempt from State tax.)

The Court first held (citing *Moorman*) that the Vermont tax did not violate the Due Process clause of the Constitution because there was at least a minimal connection between Mobil's activities and Vermont and because there was a rational relationship between the income attributed to Vermont and the activities in Vermont. These criteria were met with respect to the apportioned dividend income because it represented the earnings of Mobil's unitary petroleum business. In this regard, the Court looked to the underlying activities of the subsidiaries.

The Court also held that the Vermont tax did not violate the Interstate Commerce clause of the Constitution because the four criteria for State taxation (outlined above in the discussion of *Japan Lines*) had been met. Mobil failed to show that Vermont's apportionment resulted in double taxation because New York did not tax the dividends. In the absence of actual multiple taxation, the Court found no reason to require Vermont to switch from its apportionment method to a method which would allocate the dividends entirely to New York.

Finally, the Court found no violation of the Foreign Commerce clause. Mobil took the position that the dividends should be taxable only in the jurisdiction of domicile, on an analogy to *Japan Lines*, in which the Court had held that the containers should only be taxable in Japan. The Court observed, however, that Mobil's case did not involve international double taxation; rather, Mobil was arguing that double taxation might occur as among the States. However, such double taxation would be within the power of the Court to remedy, so the special considerations of *Japan Lines* on this point were not applicable. The Court further declined to hold that considerations of Federal tax policy required Vermont not to tax the dividend income, in the absence of an explicit directive from the Congress.

Mobil argued in its reply brief that, if its dividends from its affiliates were to be included by Vermont in income subject to apportionment, then the property, payroll and sales of those affiliates should be taken into account in determining the amount of income apportionable to Vermont. (This method would be similar to the combined reporting method as in effect in California.) The effect of including the property, payroll and sales of the affiliates in the apportionment fraction would have been to reduce the income apportionable to Vermont, because the activities of these affiliates were outside the State. However, the Court held, on procedural grounds, that Mobil had waived its right to advance this argument. Accordingly, the Court made no decision as to whether this combined reporting would be constitutionally required.[1] This holding as to the procedural posture of the case was in large part the basis of a dissent by Mr. Justice Stevens, who argued that consideration of the property, payroll, and sales of affiliates in the apportionment fraction would be required if Vermont sought to tax Mobil's dividend income from those affiliates.

B. Prior Congressional Action

In response to U.S. Supreme Court decisions in the late 1950s upholding the power of States to tax income from interstate commerce, Congress enacted Public Law 86–272 (15 U.S.C. §§ 381–84). That law provides that, in general, no State or locality may impose an income tax on any person engaged in interstate commerce if the only activities of the person in the State are the solicitation of orders for tangible personal property which are sent outside the State for acceptance and are filled by shipment from outside the State. For this purpose, a person is not treated as engaged in business within the State merely by reason of the sales activities of independent contractors.

Subsequently, a number of bills were introduced which would have mandated greater uniformity in the rules for State taxation of corporations. Two of these bills passed the House of Representatives,[2] but no further action was taken.

C. Recommendations of Ways and Means Task Force on Foreign Source Income

The Ways and Means Committee, in the Tax Reform Act of 1976, agreed to a number of major changes which would have produced significant revision in the taxation of foreign source income. In addition, there were several other proposed changes in the taxation of foreign source income which were considered by the committee but which the committee decided needed further study. Therefore, the committee established a task force to analyze the issues involved and to recommend to the full committee any appropriate legislative changes.[3] The

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[1] This issue was also raised in *Asarco Inc. v. Idaho State Tax Comm'n* (No. 78–1839), vacated and remanded by the Supreme Court for further consideration in light of *Mobil*.

[2] H.R. 2158 (90th Cong.) and H.R. 7906 (91st Cong.).

[3] The task force was comprised of 10 members of the Ways and Means Committee, with Mr. Rostenkowski as chairman. It submitted its report on March 8, 1977.

proposals referred to the task force included proposals to limit the manner in which States could take into account the operations of foreign affiliates of U.S. corporations.

The task force made the following recommendations with respect to State taxation of foreign source income:

(1) *Income of foreign affiliates not subject to Federal income tax.*—It was recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income was subject to Federal income tax. (The provisions of H.R. 5076 prohibiting the application of the unitary method on a worldwide combination basis generally follow this recommendation. See Part V.A. below.)

(2) *Income of foreign affiliates subject to Federal income tax.*—It was recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income became subject to Federal income tax. (The provisions of H.R. 5076 exempting foreign source dividends do not follow this recommendation. See Part V.B. below.)

D. Tax Treaties

As originally negotiated, Article 9(4) of the recently ratified tax treaty between the United States and the United Kingdom would have prevented the Federal government and the States from extending the unitary method on a worldwide combination basis to related foreign enterprises where the enterprise doing business in the State was either a British enterprise or a U.S. corporation controlled directly or indirectly by a British enterprise. Thus, for example, if a U.S. branch of a British corporation did business in a State, that State could not apply the unitary method to combine the income (and sales, payroll, and property) of any related foreign enterprises (from the United Kingdom or any third country) with those of that British corporation in determining the income of its U.S. branch which is taxable by that State. Alternatively, if the British corporation did not do business in the State, but had a U.S. subsidiary doing business in the State, that State, in determining the taxable income of that U.S. subsidiary, could not apply combined reporting requirements to include the income (and the sales, payroll, and property factors) of the British parent corporation or other related foreign enterprises.

When the treaty was first considered by the U.S. Senate, Senator Church proposed a reservation which would have had the effect of deleting from the treaty this provision as applied to the States. The reservation lost on the Senate floor by a vote of 34 yeas, 44 nays. However, the Senate thereafter, by a vote of 49 yeas, 32 nays, failed to concur in the proposed treaty containing the State taxation provision by the required two-thirds vote (ratification would have required an affirmative vote of 54 of the 81 Senators voting). After the Treasury Department announced that it would accept the treaty with a reservation deleting the limitation on the States, the Senate reconsidered

the treaty and gave its advice and consent to ratification of the treaty, subject to the Church reservation, by a vote of 82 yeas, 5 nays. The reservation was subsequently incorporated in a protocol to the treaty, which was approved by the Senate on a unanimous vote of 98 yeas. In its report on the protocol, the Senate Foreign Relations Committee urged the tax-writing committees of the Congress to hold hearings on the issues presented by Article 9(4) of the U.K. treaty.[4]

The question of combined reporting requirements of U.S. States was also discussed in an exchange of notes accompanying a recent protocol to the tax treaty with that country. France took the position that for a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a State of the United States, in English, imposes a costly burden. However, no provision regarding this issue was incorporated into the protocol.

Income tax treaties which the United States has entered into with other countries generally contain "nondiscrimination" clauses which prohibit both the Federal government and the States from imposing on foreign taxpayers heavier tax burdens than are imposed on similarly situated domestic taxpayers. Limitations on State taxation have also been included in a number of Friendship, Commerce, and Navigation treaties of the United States. Of particular relevance here is the commercial treaty with France signed November 25, 1959 (TIAS 4625, 11 UST 2398), which provides in part that companies of either country engaged in the business in the other would not be subject to any form of taxation upon capital, income, profits, or any other basis, except by reason of their operations in that country or any other bases of taxation directly related to their activities within that country. This provision applies to political subdivisions such as the States as well as to the two national governments. Certain foreign-based multinational corporations and certain foreign governments take the position that provisions such as this prohibit the application of the unitary method on a worldwide combination basis in the case of foreign-based multinationals covered by the provisions.

E. GAO Study

Because of the possibility that Congress might, in the next few years consider legislative proposals regarding limitations on the States power to use certain methods of taxing multinational corporations, on May 3, 1978, Chairman Ullman asked the General Accounting Office to undertake a study for the committee of the methods used by the States in taxing multinational corporations. The GAO study will also cover the application of the Federal tax rules under Code section 482. GAO expects that its report will be issued during December 1980.

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[4] U.S. Exec. Rep. No. 96–5, 96th Cong., 1st Sess. 6 (1979).

IV. ISSUES

A. Prohibition of Worldwide Combination

1. Should Federal legislation be enacted which would prohibit (or limit) the application by the States of the unitary method on a worldwide combination basis (that is, the California method). (See part I.A. of this pamphlet.)

2. Even if such a provision were not adopted with respect to multinational corporations based in the United States, should Federal legislation be adopted to preclude the States from applying the unitary method on a worldwide combination basis to foreign-based multinational groups of corporations?

B. Exemption of Foreign Source Dividends

1. Should the States be required to exempt dividends received by U.S. corporations from foreign corporations to the extent that those dividends have borne foreign income taxes at rates comparable to the maximum Federal corporate income tax rate of 46 percent?

2. Should States be required to exempt all, or substantially all, of the dividends U.S. corporations receive from other U.S. corporations where substantially all the income of the distributing corporations is derived from foreign sources?

V. DESCRIPTION OF LEGISLATIVE PROPOSAL

H.R. 5076 (MESSRS. CONABLE AND JONES)

A. Prohibtion of Worldwide Combination

The first part of the bill would, in general, prohibit the States (or their political subdivisions) from taking into account, through the application of the unitary method on a worldwide combination basis or by any other method, the income of foreign affiliates of corporations doing business within the States until and unless that income is subject to Federal income tax. The corporation doing business within, and subject to tax by, the State would generally be a corporation organized under U.S. law, but it could also be a U.S. branch of a foreign corporation. In the following discussion of the legislative proposal, the term "U.S. corporation" will be used to refer, in either case, to the corporation doing business in the State.

As an exception to this general rule, the State or locality may include in the income of the U.S. corporation any income of the foreign corporation which is includible in the U.S. corporation's income for Federal purposes under the income tax provisions of the Code. For example, tax haven income of a controlled foreign corporation which under subpart F (Code secs. 951–964) is includible in the U.S. corporation's income for Federal tax purposes [1] could also be taxed at the State or local level (subject, however, to the bill's special rules regarding dividend income discussed in the following section).

The legislative proposal would thus prohibit, for example, the use of the worldwide combination method of reporting now in effect in California. Under that method, the income of foreign affiliates of a corporation subject to tax in California is included in total income subject to apportionment if the activities of the two corporations are part of a unitary business. (The property, payroll, and sales of the foreign corporation are also taken into account in determining the amount of income apportionable to California.) This part of the proposal would not affect the present manner of applying the unitary method employed by states such as Vermont which, unlike California, generally do not include the operations of foreign affiliates in the combined report but which, unlike California, do actually tax the earnings when they are received as dividends. However, the provisions of the proposal regarding dividends received from foreign affiliates (discussed below) would affect those States.

For purposes of the bill, an "income tax" is defined as any tax which is imposed on, according to, or measured by income. Thus, for example, a tax on the privilege of doing business in a State in a corporate form, which is measured by income, would be an income tax. For pur-

[1] Under subpart F, a foreign corporation is generally a controlled foreign corporation (CFC) if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom owns at least 10 percent of the voting power. The U.S. shareholders are generally required to include currently in their income (as a constructive dividend) their pro rata shares of certain undistributed tax-haven and passive income of the CFC.

poses of determining whether the taxable corporation and the foreign corporation are affiliated, the bill defines the term "affiliated group" to mean a common parent corporation and one or more chains of corporations connected through stock ownership with the common parent corporation.

Certain corporations organized under U.S. law would be treated as foreign corporations for purposes of these provisions of the bill, and, thus, their income generally could not be taken into account in determining the liability of the taxable corporation. A domestic corporation generally would be treated as foreign if less than 20 percent of its gross income for the preceding three years was from sources within the United States. Included in this category would be Domestic International Sales Corporations (DISCs) and also possessions corporations (Code secs. 931 and 936).

B. Exemption for Dividends from Foreign Sources

The bill also would prescribe a partial or complete exemption for dividends received by the U.S. corporations from (1) foreign corporations and (2) U.S. corporations most of whose income is from foreign sources. These exemptions apply whether or not the corporations paying and receiving the dividends are affiliated.

Dividends from foreign corporations.—In the case of dividends received from a foreign corporation, the bill would provide that the amount of income to be taken into account may not exceed the lesser of (1) the actual amount of the dividend received, net of any foreign income taxes on the income but not reduced by foreign withholding taxes, or (2) a formula amount intended to take into account foreign taxes imposed on the dividend or on the income from which the dividend is paid.[2]

The net effect of this limitation would be that where the aggregate rate of foreign income taxes paid by a U.S. corporation with respect to the dividends it receives from its foreign subsidiaries (including the foreign income taxes paid by the foreign subsidiaries which are attributable to the earnings distributed to the U.S. parent corporation) equal or exceed the 46-percent U.S. Federal income tax rate, no part of the dividends received by the U.S. corporation from its foreign subsidiaries could be taxed by the States. Where the aggregate foreign tax rate is less than 46 percent, a proportionate part of the dividends would be exempt from state income tax (if the foreign rate is half of the Federal rate, half the foreign dividends would be exempt; if the foreign rate is one-quarter of the Federal rate, one-quarter of the foreign dividends would be exempt, etc.). Since most U.S. corporations pay (or are deemed to have paid) foreign income tax with respect to dividends from foreign subsidiaries at rates comparable to the 46-percent U.S. Federal income tax rate (determined on an overall basis for all dividends received by the U.S. corporation from foreign affiliates), it can be expected that for most U.S. corpora-

[2] The following discussion assumes that the taxable corporation elects to credit, rather than deduct, foreign income taxes and that it has the 10-percent or larger interest in the foreign corporation required in order to claim the foreign tax credit for taxes paid by the foreign corporation which are attributable to the dividend.

tions the bill would exempt most if not all of the dividends they receive from foreign corporations from State income taxes.

The formula limitation is determined as follows: The first step under the formula is to determine the "grossed up" amount of the dividend by adding to the amount of the dividend the foreign income taxes paid by the distributing foreign corporation which are attributable to the dividend. This "grossed up" dividend amount is then multiplied by a fraction to determine the portion of the dividend to be excluded in determining the U.S. corporation's liability under the formula. The fraction takes into account not only the particular dividend under consideration but all dividends received during the year from foreign corporations by the U.S. corporation. The numerator of the fraction is the sum of (1) the foreign taxes imposed on the income of the foreign corporations from which the dividends are paid and (2) any additional foreign tax withheld on the payment of the dividends to the U.S. corporation. The denominator of the fraction is the grossed-up amount of all foreign dividends multiplied by 46 percent, the highest corporate rate in effect at the Federal level.

The operation of this formula may be illustrated by example. Suppose that a foreign country imposes a corporate income tax at a flat rate of 23 percent (half the U.S. Federal rate) and imposes no withholding tax on the distribution of dividends. A foreign corporation earns $100 in that country, pays the foreign income tax of $23, and remits the remaining $77 to the U.S. corporation whose State tax liability is to be determined. The actual amount of the dividend is thus $77. The amount taxable under the formula is determined as follows. First, the $77 received is grossed up to include the $23 of foreign tax imposed on the income from which it was paid, for a total of $100. The portion to be excluded is determined by multiplying the grossed-up dividend amount ($100) by a fraction, the numerator of which is $23, the foreign tax paid, and the denominator of which is $46, the maximum U.S. corporate rate of tax on the $100 of income. The resulting product is $50 ($100×$23/$46), the excludable amount (half the grossed-up dividend). Thus, $50 ($100 minus the excluded $50) is subject to tax under the formula. Because this is less than $77 actually received, the State may not include more than $50, the amount determined under the formula, of the dividend in the U.S. corporation's income.[3]

[3] The actual amount of a dividend may be smaller than the formula amount if the taxable corporation also receives other dividends during the taxable year. This may be illustrated by returning to the example in which the foreign country imposed a 23 percent tax on corporate income and assuming that the U.S. corporation also received a dividend of $900 from another foreign affiliate during the year from which a foreign income tax of 5 percent ($45) was withheld. Under the formula, the grossed-up amount of the first dividend ($100) would be multiplied by a fraction, the numerator of which is the total foreign income taxes paid ($23 plus $45, or $68), and the denominator of which is 46 percent of the total grossed-up dividends (46 percent of the sum of $100 and $900, or $460). The excludible amount would thus be $100×$68/$460, or $15, and the taxable amount under the formula would be $85 ($100 minus $15). In this case, the actual amount of the dividend ($77) would be less than the formula amount, and would be the maximum subject to State or local tax. As to the $900 dividend, the actual amount of the dividend is $900. Under the formula, the exclusion is $900×$68/$460, or $133. Thus the formula limit is $767, which is less than $900 and thus would apply. The total amount which could be included in the U.S. corporation's income with respect to the two dividends would be $844 ($77 plus $767).

If the foreign country's tax rate had been 46 percent, then the actual dividend received by the taxable corporation would have been $54. The grossed-up dividend under the formula would have been $100 ($54 plus $46). The excluded amount would have been $100 ($100 multiplied by $46/$46). Thus, none of the dividend would have been subject to State taxation.

Foreign source dividends from U.S. corporations.—A separate rule would apply to exempt dividends received from a domestic corporation which is treated as foreign under the bill because less than 20 percent of its gross income is from sources within the United States. Unlike the rule which would apply to dividends from foreign corporations (described above), relief under this provision does not depend on the amount of foreign income taxes which the dividend bears. Generally, a State or locality would not be permitted to take into account the amount of any dividend received from such a corporation to the extent that the recipient corporation is allowed a dividend-received deduction under the Code. This dicidends-received deduction is generally equal to 85 percent of the dividend where the corporation receiving the dividend owns less than 80 percent of the stock of the corporation paying the dividend, so that in these situations only 15 percent of the dividend would be subject to tax (Code sec. 243(a)(1)). (Since its four U.S. shareholders each own less than 80 percent of its stock, only 85 percent of the ARAMCO dividends considered in the *Mobil* case would be exempt under this provision; the States could continue to tax the remaining 15 percent.) However, if the parent company owns (or is considered to own) at least 80 percent of the stock of the corporation paying the dividend, 100 percent of the dividends received are deductible (Code secs. 243(a)(3) and 243(b)). Thus, no State or local taxation of those dividends would be permitted. If these corporations elect to file a consolidated return, the dividends would also be fully exempt from State or local taxation under the bill (see Treas. Reg. § 1.1502–14(a)(1)). This provision would not affect the taxation by States of dividends from DISCs because they do not qualify for the dividends received deduction.[4]

C. Effective Date

The provisions of the bill would apply to taxable periods (under State or local law) beginning after December 31, 1978.

The operation of these provisions is illustrated by the following example which compares the total tax burden on $100 of income earned by a U.S. company with the total tax burden under the bill on $100 of

[4] This provision would appear to permit a U.S. corporation to insulate all its foreign source income (not just its foreign source dividends) from State taxation by placing the assets which generate that activity in a domestic subsidiary. If the subsidiary obtained its income from foreign sources, then that income could not be included in the unitary income of the parent under the first part of the bill. Moreover, a 100-percent deduction for (or elimination of) dividends from the subsidiary would be available to the parent, so no State tax could be imposed when the subsidiary paid the income to the parent as a dividend. This could be accomplished without increasing the Federal tax burden of the parent. If the committee adopts the provisions of the bill exempting foreign source dividends, it may wish to clarify whether or not this result is intended.

income earned by a foreign affiliate of the U.S. company and paid to the U.S. company as a dividend.

	Taxation of operations in United States only	Taxation of foreign source dividend foreign tax rate—			
		Zero	23%	46%	50%
Foreign tax		0	$23	$46	$50
Net U.S. tax (46%)	$42	$42	21	0	0
State tax	10	10	5	0	0
Total taxes	52	52	49	46	50

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